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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 393

THE SILL CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the court of appeals (Pet. A1-A22) is reported at 343 F.2d 411.

JURISDICTION

The judgment of the court of appeals was entered on March 4, 1965. A timely petition for rehearing was denied on April 27, 1965. The petition for a writ of certiorari was filed on July 23, 1965. The

jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether government appraisal experts were properly permitted to use the cash flow method of capitalizing income after deducting debt service to estimate market value of the interest of the sponsor in a Wherry Housing project condemned.

2. Whether, in valuing for federal condemnation purposes the sponsor's interest in a Wherry Housing project, testimony as to the ratio between income and sales price of other Wherry projects and other federally controlled housing is admissible to support the capitalization rate used by the expert witness.

STATEMENT

This is a condemnation action by the United States to acquire the interest of the builder-mortgagor (hereinafter the "sponsor") in a Wherry Housing development known as Artillery Village on government-owned land at Fort Sill in Oklahoma. The interest acquired was subject to a federally insured mortgage, the payments on which were assumed by the United States.

The history of Wherry projects has been summarized and the applicable legal principles have been clarified in this and other decisions rendered on appeals in Wherry condemnation cases.[1] The project

[1] *Winston* v. *United States*, 342 F.2d 715 (C.A. 9); *United States* v. *Certain Interests in Borough of Brooklyn (Fort*

consisted of 285 residential buildings, comprising 500 dwelling units, together with necessary appurtenances. It was constructed on 122 acres of government land under a 75-year lease, with nominal annual rental of $100 for the land. The first tenant occupied it in July 1952 and the project was completed in March 1953.

The certified actual cost of the project was $3,936,225.03, including financing expense, while the federally insured mortgage was in the amount of $4,300,000 (R. 786-787; Pl.Ex. 7-10, 20). The difference of approximately $363,000 between the certified actual cost and the amount of the mortgage, which was received by the sponsor, is referred to as "excess mortgage proceeds" or "windfall" (R. 679, 684). On the date of taking, September 1, 1959, the unpaid mortgage balance was $3,822,104.55 (R. 80).

The maximum return from rentals permitted by FHA in Wherry projects is 6½% of FHA's estimate of original cost. The rentals which may be charged

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Hamilton), 326 F.2d 109 (C.A. 2), certiorari denied, 377 U.S. 978; *United States* v. *Certain Interests in Champaign County, Ill. (Chanute Gardens)*, 271 F.2d 379 (C.A. 7), certiorari denied, 362 U.S. 974; *United States* v. *Benning Housing Corp.*, 276 F.2d 248 (C.A. 5); *Buena Vista Homes, Inc.* v. *United States*, 281 F.2d 476 (C.A. 10); *United States* v. *Leavell & Ponder, Inc.*, 286 F.2d 398 (C.A. 5), certiorari denied, 366 U.S. 944; *United States* v. *Johnson*, 285 F.2d 35 (C.A. 9); *United States* v. *Tampa Bay Garden Apartments, Inc.*, 294 F.2d 598 (C.A. 5); see also *Henry Barracks Housing Corp.* v. *United States*, 150 C.Cls. 689, 281 F.2d 196; *Likins-Foster Monterey Corp.* v. *United States*, 308 F.2d 595 (C.A. 9); *Fairfield Gardens, Inc.* v. *United States*, 306 F.2d 167 (C.A. 9).

military personnel are fixed on that basis and, while rents may be raised to meet increased operating costs, taxes, etc., the maximum dollar return allowed to the project remains that fixed at the time of original processing. In this case the return allowed was $319,196 at 97% occupancy which is approximately 6.5% of the estimated cost and 8.59% of the certified actual cost (Pl.Ex. 8).

The sponsor is also required to maintain a reserve fund for replacements of short-lived equipment (stoves, refrigerators, etc.) in a separate account throughout the life of the mortgage. Here, the sponsor's deposits annually totaled $27,115. Shortly after the date of taking, the sponsor, by agreement, received the amount then accumulated in this reserve, approximately $167,000 (R. 79-80, 346-347, 448-449; Pl.Ex. 11, 29.)

There were extensive pretrial hearings. The district court ruled, *inter alia*, that evidence would be permitted as to the valuation approaches of market data and capitalization of net income both before and after debt service[2] (adding, at petitioner's request, "[w]ith full right of * * * cross-examination * * *"), and that evidence would be admitted as to sales of comparable investments, including other Wherry projects "for the purpose of showing the relative risk, the ratio of overall prices to net income before debt service, and the ratio of equity price to net

[2] This means net cash return after depreciation, mortgage insurance expense, and principal and interest payments are deducted.

income after debt service" (R. 82). The pretrial order further provided (R. 83): "Neither counsel nor any witness for either party shall, in the presence or hearing of the jury, use the word 'windfall' in the trial of this cause unless approval is obtained in advance from the Court; however, the words 'excess mortgage proceeds' may be used." The district court indicated that the pretrial order would be modified in the course of the trial if necessary (R. 199, 212).

The issue of just compensation was tried before a jury. The appraisal witnesses for both parties relied mainly on the capitalization of income approach. Petitioner's witnesses Vaughan, McKean, Noah and Williamson capitalized net income before debt service. Vaughan capitalized an estimated income of $323,785 before debt service at 6% for a 40-year period and then subtracted debt service, reaching a value opinion of $1,397,895 (R. 406-422). He also capitalized net income after debt service (cash flow) but only as a check (R. 416-419). McKean capitalized $316,391 at 6¼% for a 50-year period, subtracted the unpaid debt, and testified to $1,111,000 as value (R. 469-471, 474). He said his capitalization rate was a "judgment figure" and his "best judgment" and "opinion" (R. 469-470). Noah's valuation opinion of $1,200,000 was reached by his capitalizing $319,157 by 6¼%, over the remaining 66 years of the lease, using an Inwood factor of 15.76;[3] he then subtracted the mortgage balance (R. 504-507).

[3] This factor represents present value of payments to be made in the future.

Williamson analyzed three other Wherry transactions (R. 528 *et seq.*), concluding that they were useful here in selecting a capitalization rate (R. 529). He capitalized $322,297 at 6¼%, for a 50-year period, using an Inwood factor of 15.272, subtracted the mortgage balance, and by that process estimated compensation at $1,100,000 (R. 538, 546-548).

The government's valuation witnesses, Monrad and Sealy, testified that they had made extensive investigations of buyers and sellers, or investors, in other housing projects, particularly those financed through government-insured mortgages, and stated that their investigation disclosed that investors considered they were buying and selling equities and were dealing on the basis of capitalizing the equity income, *i.e.*, net income after payment of debt service. Both referred to three other Wherry transactions as providing a basis for a ratio of income to equity (R. 747-748, 808-809). Monrad estimated net income after debt service (cash flow) to be $63,300, which he capitalized at 21.5% (R. 737). In addition to using other methods, he also capitalized net income before debt service but at a rate of 7.18% (R. 735-748). His estimate of value was $302,000 (R. 746). The cash flow or equity income in Sealy's opinion was $68,241 which he multiplied by 6.67, the product being $455,167; he subtracted the reserve for replacement and reached a valuation of $290,000 (R. 807-808).

The jury awarded $302,000. Judgment was entered thereon and the sponsor's motion for new trial, as amended, was denied. The court of appeals affirmed, holding that (1) capitalization of income after de-

duction of debt service was not an improper valuation method (Pet. App. A6-A10); (2) testimony regarding the ratio of sales price to income of other Wherry and federally controlled housing is admissible to support the experts' selection of a capitalization rate (Pet. App. A10-A11); (3) the government experts' deduction of the replacement reserve fund from their estimates of value was proper because the sponsor had received the fund and there was testimony that the property was in need of repair (Pet. App. A11-A13); (4) evidence of excess mortgage proceeds or windfall was admissible as bearing on market value, since it was shown that FHA would consider the existence of windfall in reviewing a request for rental increases (Pet. App. A13-A18); (5) FHA policy letters relating to windfall and requests for rental increases were relevant, even though not promulgated pursuant to the Federal Register Act or the Administrative Procedure Act (Pet. App. A17); and (6) government counsel's reference, without objection, in closing argument to the sponsor's receipt of a windfall was not prejudicial since "the excess mortgage proceeds did prove to be a windfall and, as such, it was not wholly irrelevant to the ultimate issue of just compensation" (Pet. App. A21).

ARGUMENT

1. Petitioner first challenges the use by the government's appraisal experts of the cash flow method of valuation which capitalizes net income after deduction of debt service (Pet. 9-21). That method, we

submit, is proper because it is the most direct approach to valuing the interest being condemned. Ignored by petitioner is the fact that a Wherry sponsor's interest is a limited one. Thus, the sponsor's interest is different from the equity interest of the ordinary mortgagor whose payments accumulate an increasing property interest which ultimately becomes a fee title interest.

As the court of appeals noted (Pet. App. A8-A9, note 6): "The fallacy of this argument [the sponsor's view that debt service should be disregarded] may be in the fact that the only interest taken here is a possessory right in a lease. This reasoning would be applicable if the owner in this case acquired an equity through the amortization of the mortgage. The mortgage payments, although commensurate with the income, would nevertheless operate to enhance his equity in the property. But, in our case, the owner can acquire no equity in the mortgaged property. The nature of his estate therein is purely possessory—the right to the income or the benefits, after discharge of all of the burdens. * * *" Thus, even if and when a sponsor does discharge the mortgage, its right to operate the project would still be restricted and controlled and it could not even then transfer its interest free of the restrictions.[4]

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[4] This is not contrary to *Offutt Housing Co.* v. *Sarpy County*, 351 U.S. 253 (Pet. 10). That case involved the applicability of the County's personal property taxes to a Wherry sponsor's buildings, improvements, appliances, and furniture. There was no question there as to the valuation of the sponsor's interest upon condemnation by the United States. See

Use of the cash flow method of valuation has been approved by other courts of appeals in Wherry cases. None has rejected it on challenge.[5] Appraisal literature likewise supports the use of this method. Kaffenberger, *Market Data in the Appraisal of Income Property*, 28 The Appraisal Journal 57-62 (1960). There was also testimony that the method was endorsed by appraisers and included in appraisal courses

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United States v. *Benning Housing Corp.*, 276 F.2d 248, 253, note 19 (C.A. 5).

Nor is there conflict with *DeLuz Homes* v. *County of San Diego*, 45 Cal.2d 546, as asserted (Pet. 17-18). In that case the County was levying a tax on the value of the entire leasehold interest. Therefore, the court correctly held that, in valuing that interest, it was error to require the County to deduct annual debt service from annual income to be capitalized because that process is a subtraction of a part of the figure that is being determined. Also, that case involved the assessment of property for taxation under California law and not the determination of just compensation. While the court discussed the question of deductions for amortization, its decision was based on the provisions of California law which prohibited the deduction of "credits secured by mortgage or trust deed" (45 Cal.2d at 573). This is clearly brought out in the companion case of *Fairfield Gardens* v. *County of Solano*, 45 Cal.2d 575, 578.

[5] See *United States* v. *Tampa Bay Garden Apartments, Inc.*, 294 F.2d 598, 601-602, 607 (C.A. 5); and *Likins-Foster Monterey Corp.* v. *United States*, 308 F.2d 595, 601-602 (C.A. 9). This method was also used and challenged in *Winston* v. *United States*, 342 F.2d 715, 717, note 1 (C.A. 9); *United States* v. *Certain Interests in Borough of Brooklyn (Fort Hamilton)*, 326 F.2d 109, 112-113 (C.A. 2), certiorari denied, 377 U.S. 978; and *United States* v. *Certain Interests in Champaign County, Ill. (Chanute Gardens)*, 271 F.2d 379, 381-382 (C.A. 7), certiorari denied, 362 U.S. 974. These courts did not think the challenge worth answering.

(R. 716, 750, 849-851). Indeed, one of petitioner's own witnesses used the method, albeit only as a check on value (R. 416-419). This is a sufficient answer to petitioner's assertion that "[v]alue through capitalization of income can be obtained only by using net income prior to any deduction for debt service" (Pet. 18). But, in any event, petitioner is in no position to assail the district court's submission of both theories to the jury because, as the court of appeals observed (Pet. App. A6-A7), it acquiesced in that course, "if we are not restricted in any way on our cross examination of that point" (R. 130). And, of course, there is no basis for a complaint that the jury apparently accepted the government's theory, since petitioner in closing argument asked the jury not to compromise the divergent theories but to accept one and reject the other (R. 980-981).

2. The testimony of the government's witnesses as to sales of stock in Wherry and other federally controlled housing was properly admitted. It focused upon the ratio between sale price and income, and was introduced, not as direct proof of value, but as support for the government's estimate of the appropriate rate of return to be used in applying the capitalization of income method.[6]

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[6] This distinguishes *United States* v. *190.71 Acres in Lake County, Ill. (Corbetta-Price)*, 300 F.2d 52 (C.A. 7); and *In re United States Commission*, 295 Fed. 950 (C.A. D.C.), relied upon by petitioner (Pet. 13-15). See *United States* v. *Certain Interests in Borough of Brooklyn (Fort Hamilton)*, 326 F.2d 109, 113-114 (C.A. 2), certiorari denied, 377 U.S. 978.

The key factor in the capitalization process is the rate selected, and the logical way to determine the capitalization rate is, we submit, by examination of the income flows generated by comparable investments. In this connection, it is unimportant that the sales were of stock rather than of land. "Since Wherry corporations are precluded from engaging in any business other than the operation of Wherry leaseholds, the consideration given for the stock can be regarded as the price paid for the underlying leasehold." *United States* v. *Certain Interests in Borough of Brooklyn (Fort Hamilton)*, 326 F.2d 109, 113, note 3 (C.A. 2), certiorari denied, 377 U.S. 978.

The reasonableness of this selection process has been concurred in by all circuits which have considered it. In addition to *Fort Hamilton*, see *Winston* v. *United States*, 342 F.2d 715, 720-721 (C.A. 9); *United States* v. *Leavell & Ponder, Inc.*, 286 F.2d 398, 407 (C.A. 5), certiorari denied, 366 U.S. 944; *United States* v. *Benning Housing Corp.*, 276 F.2d 248, 253 (C.A. 5); *Likins-Foster Monterey Corp.* v. *United States*, 308 F.2d 595, 600 (C.A. 9). Moreover, one of petitioner's own witnesses made the same use of such transactions (R. 528-530, 541, 544) and it is accordingly foreclosed from raising the objection in this case.

3. Petitioner's other contentions—(a) that the accumulated reserve for replacement fund, returned to petitioner by agreement, was improperly deducted; (b) that excess mortgage proceeds or windfall did not exist in this case and the question pertaining thereto was improperly introduced because no valid

policy had been promulgated by FHA; and (c) that government counsel recklessly used the term "windfall"—are insubstantial and were properly rejected by the court below (Pet. 20-29; Pet. App. A13-A22).

CONCLUSION

Since the decision below is clearly correct, and there is no conflict or any other reason for intervention by this Court, we respectfully submit the petition for a writ of certiorari should be denied.

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AUGUST 1965

☆ U. S. GOVERNMENT PRINTING OFFICE: 1965 765165 138